



CRS Report for Congress

China's "Hot Money" Problems

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Summary

China has experienced a sharp rise in the inflow of so-called "hot money," foreign capital entering the country supposedly seeking short-term profits, especially in 2008. Chinese estimates of the amount of "hot money" in China vary from \$500 billion to \$1.75 trillion. The influx of "hot money" is contributing to China's already existing problems with inflation. Efforts to reduce the inflationary effects of "hot money" may accelerate the inflow, while actions to reduce the inflow of "hot money" may threaten China's economic growth, as well as have negative consequences for the U.S. and global economy. This report will be updated as circumstances warrant.

Economic conditions in China are of considerable concern to U.S. policymakers, given the potential impact of China's economy on the global and U.S. economy. The recent large inflow of financial capital into China, commonly referred to as "hot money," has led some economists to warn that such flows may have a destabilizing effect on China's economy. In an op-ed column in the *Financial Times*, two China experts wrote of hot money's "ensuing money creation is fueling rising inflation, systemic overinvestment, and an overextended banking system."¹ There are also indications that "hot money" flows have played a role in the recent rise and fall of China's stock and real estate markets. Other economists have expressed concerns that efforts by the Chinese government to control "hot money" inflows could have significant negative consequences for the U.S. and global economy in the form of slower growth, greater inflation, or both.

Defining "Hot Money"

There is no formal definition of "hot money," but the term is most commonly used in financial markets to refer to the flow of funds (or capital) from one country to another in order to earn a short-term profit on interest rate differences and/or anticipated exchange rate shifts. These speculative capital flows are called "hot money" because they can move very quickly in and out of markets, potentially leading to market instability. Many economists maintain that the rapid outflow of "hot money" first from Thailand and then

¹ Michael Pettis and Logan Wright, "Hot Money Poses Risks to China's Stability," *Financial Times*, July 13, 2008.

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from other Southeast Asian economies was a significant contributing factor to the onset and severity of the East Asian Financial Crisis of 1997.

Estimates of China's "Hot Money" Flows

Because "hot money" flows quickly and is poorly monitored, there is no well-defined, direct method for estimating the amount of "hot money" flowing into a country during a period of time. In addition, once an estimate is made, the amount of "hot money" may suddenly rise or fall, depending on the economic conditions driving the flow of funds. One common way of approximating the flow of "hot money" is to subtract a nation's trade surplus (or deficit) and its net flow of foreign direct investment (FDI) from the change in the nation's foreign reserves.

For the first half of 2008, China's foreign reserves increased by \$280.6 billion.² Over the same time period, China's accumulated trade surplus was \$99.0 billion and its FDI inflow was \$52.0 billion.³ Using the method described above, China received an inflow of \$129.6 billion in "hot money" during the first half of 2008.⁴ According to the former director of China's National Bureau of Statistics, Li Deshui, China's research institutes estimate that about \$500 billion in "hot money" has accumulated in China.⁵ However, Zhang Ming, an economist at the Chinese Academy of Social Sciences, reportedly estimated that \$1.75 trillion in "hot money" could have accumulated over the last five years.⁶ Some Chinese experts reportedly predict that the amount of "hot money" in China will rise to \$650 billion by the end of 2008.⁷ Some western analysts think the Chinese figures underestimate the amount of "hot money" in China because they do not take into account changes in China's monetary policies, such as the raising of reserve requirements and the creation of China's sovereign wealth fund, the China Investment Corporation. Taking into account these other factors, U.S. financial analyst Brad Setser estimates that China received over \$400 billion in "hot money" flows between April 2007 and March 2008.⁸

Causes of China's Inflow of Hot Money

While there may be some uncertainty about the precise amount of "hot money" flowing into China, there appears to be a general agreement as to why speculators are moving their capital into China. Analysts point to two key factors: (1) the relative interest

² "China's Forex Reserve Reaches \$1.809 Trillion by June," *Xinhua*, July 14, 2008.

³ Trade data from "China's Trade Surplus Falls Nearly 11% in H1," *China Daily*, July 10, 2008; FDI figure from "Rising FDI Reflects Inflow of Hot Money," *China Daily*, July 12, 2008

⁴ All figures from "Hot Money Flows Accelerate into China's Reserves," *China Stakes*, June 1, 2008.

⁵ "Restless Hot Money Inflows May Worsen China's Inflation Risk, Warns Political Advisor," *Xinhua*, March 8, 2008.

⁶ "'Hot Money' May Not Be that Hot," *China Daily*, July 15, 2008.

⁷ "Authority: Hot Money has Negative Impact on China's Economy," *Xinhua*, May 12, 2008.

⁸ Brad Setser, "Scary. But Just How Scary? Chinese Foreign Asset Growth and Hot Money Flows," *Brad Setser's Blog: Follow the Money*, June 3, 2008.

rates in China and the United States; and (2) expectations of the future appreciation in the value of China's currency, the renminbi (RMB).⁹

Over the last year, interest rates in China and the United States have been moving in opposite directions. The U.S. Federal Reserve lowered the federal funds rate nine times over the last year from a high of 5.25% in June 2007 to its current low of 2.00%.¹⁰ Over the same time period, the People's Bank of China raised its benchmark one-year interest rate on deposits from 2.52% to 4.14%.¹¹ The reversal in the relative interest rates of the two nations has created an incentive for investors to move their deposits from the United States to China in order to earn a higher rate of return.¹²

In addition to the attraction of the interest rate difference, speculators are moving "hot money" into China because of the general expectation that the RMB will continue appreciate in value against the U.S. dollar and other currencies. On July 21, 2005, China announced it was dropping its fixed exchange rate policy for a "managed float" policy that would allow the value of the RMB to fluctuate within a specified range on a daily basis.¹³ Since then, through July 15, 2008, the RMB has appreciated in value by 21.6%. Most analysts expect the Chinese government to continue the RMB's appreciation.

The combined effects of the interest rate differences and the expected appreciation of the RMB provide a strong incentive for "hot money" flows into China. Li Yang, a financial researcher at China's Academy for Social Sciences calculated that "hot money" speculators can obtain profit rates of over 10% per year with little investment risk.¹⁴

In theory, despite its recent capital market liberalizations, China still maintains some restrictions over foreign exchange and international capital flows, providing it with various instruments to prevent the inflow of the unwanted "hot money."¹⁵ However, sources report that speculators are using various methods to circumvent Chinese laws and regulations. According to a Deutsche Bank survey of 200 companies and 60 "high income" individuals, over half of the "hot money" coming into China is being done in the form of overreported or false foreign direct investment (FDI).¹⁶ An additional 11% of the "hot money" is generated by underreporting the value of imports, and another 10% comes from the overvaluing exports. The Deutsche Bank study also reported that 5% of the "hot money" enters China via "underground money exchangers" (*dixia qianzhuang*).

⁹ China's currency is officially called the renminbi, or "people's currency." It is often referred to as the yuan, which is actually its unit of denomination.

¹⁰ Data from the Federal Reserve Bank of New York.

¹¹ Data from the People's Bank of China.

¹² "Hot Money: Both Inflows and Outflows Have China Worried," *China Stakes*, March 25, 2008.

¹³ See CRS Report RL32165, *China's Currency: Economic Issues and Options for U.S. Trade Policy*, by Wayne M. Morrison and Marc Labonte.

¹⁴ "Why Hot Money is Sizzling in China," *Beijing Review*, May 24, 2008.

¹⁵ See Zhichao Zhang, "Capital Controls in China: Recent Developments and Reform Prospects," Durham University Business School, February 2006.

¹⁶ Ma Jun, "What are the Wherefores and Whys of Channeling 'Hot Money' Flows?," *Caijingwang*, May 28, 2008 (in Chinese).

Employee compensation (wages sent to China by overseas workers and remuneration paid by Chinese enterprises to overseas staff working in China) and current transfers (emigrant remittances, gifts, and donations) may be another major source of hot money.¹⁷

According to some analysts, U.S. economic policies (and the slow U.S. economy) may be exacerbating China's "hot money" problem, creating a "Catch-22" situation for Beijing.¹⁸ Years of large federal deficits and comparatively low U.S. interest rates have contributed to the weakening of the U.S. dollar against many currencies (including the RMB) and the outflow of "hot money" from the United States. One Chinese official indicated that he thought the U.S. subprime crisis was also fueling "hot money" flows.¹⁹

Impact of "Hot Money" on China's Economy

The main concern in China over the influx of "hot money" has been that it may add to China's inflationary pressures. In July 2008, the government reported that the consumer price index had risen by 7.9% over the first half of 2008 over the same period in 2007 (due largely to food prices), which was much higher than the government's target ceiling of 4.8%, and the producer price index rose by 7.6%. High inflation is a serious issue for the government because of concerns that rapid inflation could produce protests and political instability.²⁰ At the same time, the government needs rapid growth to help employ the 27 million new job seekers each year.

Under Chinese law, most foreign exchange entering the country must be converted into RMB. The large flow of "hot money" is causing a sharp rise in China's money supply, resulting in inflation. The Chinese government has attempted to "sterilize" the foreign exchange by selling bonds to "soak up" the RMB put into circulation, but this has resulted in higher interest rates that attract even more "hot money." China has attempted to nullify the inflationary impact of "hot money" by other means, such as the imposition of lending quotas on banks, increasing the ratio of reserves commercial banks are required to maintain (it was raised to 17.5% in June 2008 compared to 9.0% in January 2007), raising interest rates, instituting government controls to limit investment in overheated sectors (such as real estate and the steel industry), and imposing price controls on certain products (mainly food and energy). A big concern by some Chinese analysts is that "hot money" may be creating bubbles in its stock and real estate markets, although recent evidence suggests that the "hot money" is being largely deposited into bank accounts.²¹

¹⁷ "Hot Money: How the Hell Does It Get into China?" *China Stakes*, June 10, 2008.

¹⁸ Pieter Bottelier, "China's 'Catch-22' Situation," *China Stakes*, January 21, 2008.

¹⁹ "Foreign Investments, Hot Money Come to China," *China Daily*, March 13, 2008.

²⁰ There have been some minor protests in China over the current round of inflation. The high inflation in 1989 — the official CPI rose by 18% — contributed to the social unrest that spring.

²¹ Logan Wright, "Hot Money in China: Where's It Going and How's It Troubling?" *China Stakes*, July 14, 2008.

China's Options for Dealing with "Hot Money" Flows

If the Chinese government determines it is necessary to take action, it has a number of options on how to slow down the flow of "hot money." However, each option has potentially negative side effects.

Appreciate — or Depreciate — the RMB. An increase in the value of the RMB would arguably be an effective option for controlling inflationary pressures caused by "hot money." A sharp appreciation in the RMB vis-a-vis the dollar — either by a sharp revaluation or quickening the pace of appreciation under its "managed float" regime — would eliminate one of the two main incentives driving the speculators.²² The move would probably lower the price of imports (including raw materials) and possibly slow the growth in foreign exchange reserves. Other analysts have suggested that China depreciate the RMB, a move that would undermine the speculators, but could prompt Congress to pass currency legislation (including sanctions) against China.²³

Some Chinese officials contend that although a stronger RMB might reduce inflationary pressures, it would also likely raise the price of China's exports and diminish China's attractiveness as a destination for FDI, leading to widespread layoffs, factory closings, and slower economic growth.²⁴ While export growth over the first six months of 2008 has been strong (up 22% over the same period in 2007), there is concern that rising costs in China and economic weakness in the United States could greatly slow China's export growth and reduce the domestic value of its foreign exchange reserves.

Regulate the Flow of Capital. Another option for slowing the inflow of "hot money" is to tighten restrictions on the flow of foreign capital into China, a trend contrary to recent U.S. efforts to persuade China to liberalize its financial markets. During his first speech as Vice Premier on May 9, 2008, Wang Qishan spoke of "reinforcing supervision over cross-country capital flow."²⁵ There have also been reports that China is tightening its supervision of bank accounts held by non-residents to curb the influx of "hot money."²⁶ In addition, China could attempt to further promote the outflow of capital to reduce the inflationary impact of "hot money," using some of its foreign exchange reserves.²⁷ However, many policymakers, including those in the United States, are concerned over the potential impact of wide-scale (and potentially government directed) Chinese investment in "strategic" economic sectors (such as oil and gas, high technology, etc.).

²² Interest rate differentials being the other major incentive.

²³ Qian Wang, "China's Policy Options for Dealing with Capital Inflow," Economic Research Note, JPMorgan Chase Bank, Hong Kong, May 16, 2008.

²⁴ Rising costs (such as increased wages) in China and an appreciating RMB are already prompting foreign manufactures to relocate to lower cost countries, such as Vietnam and Cambodia. An article in *China Daily* (June 28, 2008) quoted a Hong Kong business association official as predicting that 20,000 Hong Kong firms in Guangdong Province (29% of total Hong Kong firms located there) may shut down or move their operations in 2008 due to rising costs.

²⁵ "Wang Qishan Eyes Financial Risk and Hot Money," *China Stakes*, July 7 2008.

²⁶ "China to Monitor Non-residents Bank Accounts," *China Daily*, June 19, 2008.

²⁷ China's overseas direct investment totaled about \$91 billion (cumulative) at the end of 2006.

Implications for Sino-U.S. Relations

Some U.S. analysts contend that the large levels of “hot money” pouring into China will force China to accelerate the appreciation of the RMB relative to the U.S. dollar and make the government enact other reforms to make the currency more flexible. This, they maintain, could in the short run help boost U.S. exports to China and reduce imports from China, thus improving the U.S. bilateral trade balance with China.²⁸ Others warn that appreciating the RMB would also make U.S. imports from China more expensive, which could add to inflationary pressures in the United States.²⁹ In addition, China might reduce its purchases of U.S. Treasury securities (used to help fund the federal deficit), which could push up U.S. interest rates.³⁰

Another concern is that Chinese efforts to fight hot money/inflation could lead to a slowdown in China’s economic growth.³¹ This could have numerous implications for the U.S. and global economies. Over the past few years, China has been one of the fastest growing economies, which has made it a major market for U.S. exports. In 2007, China surpassed Japan to become the 3rd largest U.S. export market, and thus a Chinese slowdown could reduce its demand for U.S. goods and services.³² Additionally, inflationary problems or an economic slowdown could cause Chinese officials to delay economic reforms, particularly to its financial system and currency policy.

The issues concerning the potential dangers of “hot money” flows to China reinforces the U.S. argument (and has been acknowledged by the Chinese government as a long term goal), that China needs to do more to implement policies to encourage domestic demand and lessen its dependence on exporting and fixed investment for its economic growth. Some U.S. analysts contend that adopting a free floating exchange rate is the best way to stop hot money inflows and to provide the government with the monetary tools it needs to control inflation. However, Chinese officials contend that such a move at this time would shock the economy, especially the export sector, and thus would be too risky (although they contend that a fully convertible currency is a long range goal). The “hot money” issue is a further indicator of the growing economic integration between the United States and China.

²⁸ This may already be occurring. Over the first five months of 2008, according to U.S. trade statistics, U.S. imports from China increased by only 4.4% (compared to an 11.7% increase in 2007), while U.S. exports to China grew by 22.8% over the same period in 2007.

²⁹ According to U.S. Bureau of Labor Statistics, prices of U.S. imports from China increased by 4.8% from June 2007 to June 2008, the largest 12-month increase for the China index since data was first reported in 2003.

³⁰ China was the 2nd largest foreign holder of these securities — \$507 billion as of May 2008.

³¹ Because of its currency policy, China’s ability to use monetary policy to effectively control inflation is hampered — raising interest rates would attract more hot money. The use of administrative controls, currency sterilization, and price controls may help control inflation in the short-run, but they may cause long term economic distortions that damage the economy.

³² According to the International Monetary Fund, China was the single most important contributor to world economic growth in 2007, and thus a Chinese economic slowdown could have global implications.